

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of call held with Company Q

CC note

See www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/case_study_cover_note.pdf.

Company Q is an energy company, active in more than 20 countries on five continents. It has over 6 000 employees and is a publicly listed company on the London Stock Exchange.

[redacted] had been the Group's external auditors since [redacted]. The company undertook a full tender process for external audit services [redacted] and another firm ([redacted]) was appointed.

Views of the ACC

1. The possibility of holding a tender had been raised a couple of years ago when, on assuming his role, the Audit Committee Chair (ACC) raised the question with the then Chief Financial Officer (CFO) on the grounds of good corporate governance. There was no institutional investor pressure for it at that time. The CFO favoured a pre-qualification exercise before a tender, but this was put on hold when a new CFO joined the company and other activities, such as making improvements to the finance function and commissioning an external review of the internal audit function, took priority.
2. As a result of the review of internal audit, the head of internal audit was changed. The announcement of the decision to tender the external audit was delayed until 2012, when the internal audit changes were completed. There was no sense that the incumbent was not performing adequately but, after an audit firm had been in place for some time, companies would want to look at whether they had the best and most capable audit firm on the market. The rotation of an Audit Engagement Partner (AEP) often also served as a potential trigger for testing the market, and this was a factor in the decision to tender.
3. Each of the Big 4 firms responded to the tender. The ACC did not believe that the firms lacked any incentive to bid. Audit fees were a constant, predictable income flow for the firms [redacted] and the ACC thought that the prospect of audit tenders becoming more common gave the audit firms an incentive to preserve a strong position in the market. The ACC said that there was barely sufficient choice among the big firms but the lower league firms could not provide the level of international service Company Q required).
4. The tender process involved a large number of meetings and involved intensive work for the firms in checking on possible conflicts that might compromise the independence of individual bidders. Candidates visited Company Q's overseas operations and the company factored in the views of local management in assessing the bids. AEPs in major jurisdictions were flown into London to meet with the company as part of the assessment process. A panel, including some contractors [redacted] reviewed all the tenders. Following the elimination of two of the bidders, the two front-runners gave presentations to the Audit Committee (AC). Bidders were marked in both rounds against a predetermined scoring system. Overall, the panel was satisfied that the new auditor chosen would do a better job than its predecessor in some areas. The

ACC noted that it was helpful to have an AEP [redacted] who had good judgement, intelligence, and industry experience.

5. The level of the fees proposed was a secondary issue. All the bidders shaved their offers, [redacted] but this raised some concern that the bids could have been too tight to allow the firm to provide the necessary level and scope of service.

Switching

6. The whole induction process, which was now over, had been more difficult than had been expected.
7. A major challenge for Company Q—and inherent in all major switching operations—was the reorganization of the provision of non-audit services (NAS). The AC of Company Q limited allowable charges for NAS to ([redacted] per cent) of audit fee, and it was a long process to analyse the range and nature of all Company Q's NAS. It was further complicated because some NAS could not be changed, for example those involving ongoing litigation or government negotiations. In all, about two-thirds of NAS had to be re-tendered.
8. [redacted]
9. In summary, the risks of switching were the time and resources involved, the need to deal with an outgoing audit firm and the inevitable possibility that a new auditor could miss an important matter. However, these risks should have been lifted by the end of the first year of the new audit firm's tenure.
10. The benefits a new auditor brought were to take an intelligent look at accounting judgements and to bring industry experience to bear. The auditor should take a fearless approach.
11. AEP rotation could sometimes bring similar benefits but it was double-edged. The best partners tended to focus on winning new work. When an AEP moved on, the quality of the audit tended to decline.

The CC's possible remedies

12. The ACC could see some benefit in a tender cycle of between seven and nine years, but this should not be mandatory. 'Comply or explain' was the basis of good governance.
13. The ACC saw considerably more validity in the tender process than in the annual reappointment of auditors. The auditor could not be changed without reappointing the incumbent firm at the AGM; this drove the scheduling of any tender process.
14. Mandatory rotation of audit firms would reduce the number of firms with the ability to tender; it would bring an unacceptable reduction of choice. The reduction in competition from mandatory rotation would be worsened if the incumbent firm was not allowed to tender.
15. The ACC could see some potential value in increasing the frequency of Audit Quality Review team reviews.
16. As a means of strengthening the relationship between the AC and the auditor, the ACC rejected as impractical the suggestion of removing the CFO from the fee

negotiation with the audit firm. An ACC would not be well placed to handle this without spending a great deal of time and effort to get up to speed. In his view, the AC should have no role beyond approving or, if necessary, challenging the fee. It was important to avoid confusing executive and the non-executive roles; conducting fee negotiations was an executive role.

17. On the proposed remedy of enhancing shareholder-auditor engagement, the ACC said this was an issue the Financial Reporting Council was pursuing. He noted that the level of shareholder interest in the audit was slight unless there was a crisis, and this was unlikely to change as a result of the proposals.
18. Extended reporting requirements would not be problematic but it would be important to avoid insubstantial, 'boiler-plate' reports for the sake of form.
19. In conclusion, the ACC commented that the CC market investigation was important and had taken a central position now that the European proposals had been moderated and were of less concern. The CC needed, however, to guard against the possibly unintended consequences of any changes.